

Making Time and Markets Work for the Rural Poor in the Face of Economic Vulnerability

Michael R. Carter

Professor and Director of the BASIS CRSP

Department of Agricultural & Applied Economics

University of Wisconsin



Overview

- Vulnerability and Poverty Trap Implicate Financial Markets and Fixed Costs of Investment Projects
- Now More Than Ever Financial Markets and Fixed Costs Matter
- Our Challenge is to ‘Crowd-In’ Productive Accumulation by the Poor

Vulnerability and Poverty Traps

- “Economic Vulnerability Means that [Losses] Cause **IRREPARABLE** Damage to the Livelihood of the Poor Rural Households”
- Profound Statement that Neither Time Nor Markets Work for the Poor
- So Let’s Close Our Eyes and Visualize this Problem:

$$u'(c_t) = \delta \frac{\partial J_1^*(A_{it+1})}{\partial A_{it+1}}$$

where

$$J^*(A_{it}) \equiv \max_{\{c_{it}, I_{it}\}} u(c_{it}) + J^*(A_{it+1})$$

subject to

$$c_{it} = F(A_{it}, \theta_{it}) - P_t' I_{it}$$

$$A_{it+1} = A_{it} + I_{it} - \Theta_{it}$$

$$A_{it+1} \geq 0$$

Vulnerability and Poverty Traps

- Perhaps we all did not visualize that, but we can all see a key insight from the microdynamic analysis of accumulation:
 - When financial markets are missing;
 - When there are large fixed costs to the productive investments that the poor might undertake; and, or
 - When risk and subsistence constraint render infeasible self-financed strategies of accumulation
- Then we get poverty traps—minimum wealth levels—below which accumulation and income growth are not possible.

Vulnerability and Poverty Traps

- People caught below this minimum wealth level—below the Micawber Threshold—are literally those for who ‘can’t get ahead for falling behind’
- Problem all the worse in rural areas where thin markets and immovable assets cause asset prices to covary with shocks
- Vulnerability and traps not only seen in post-shock coping behavior, but also when productive investment is displaced by in protective savings strategies
- Examples abound of large stocks of unproductive savings in rural areas, even as productive projects go unfunded.
- This inverse relationship between wealth and rate of return on wealth has been shown to worsen as risk increases

Vulnerability and Poverty Traps

- Bottom Line: Cannot expect poor people to get into a productive investment if they cannot expect to stay in

Now More Than Ever ... Financial Markets and Fixed Costs

- Fixed costs have always been a large part of one of the most important investments poor households can make:
 - The Education of the Next Generation
- Not surprising that we see low levels of education in the inequalitarian agrarian economies of the LAC region
- Fixed costs and missing financial markets also created the distorted quality of growth shown in studies of the non-traditional agro-export booms
- Tom Reardon's new work now shows us that the same forces are shifting the domestic market production as well

Now More Than Ever ... Financial Markets and Fixed Costs

- But not only are fixed costs ever more important, but rural financial markets remain as problematic as ever
- Peruvian example that illustrates both financial market weakness and its interaction with risk:

Peru			
	<i>Non-Price Rationed</i>	<i>Price Rationed</i>	
	Quantity	Risk	
% Firms	37	17	46
Wealth (\$s)	13,300	9400	24,000
Inputs (\$/ha)	451	454	868
Income (\$/Ha)	653	593	919

Source: S. Boucher and M.R. Carter (2000). "Risk Rationing and Activity Choice in Moral Hazard Constrained Credit Markets."

Now More Than Ever ... Financial Markets and Fixed Costs

- Other examples of the failure of private actors to fill the space vacated by state development banks
- We need also to think carefully about private, non-market substitutes for capital and insurance:
 - Promise of ‘social capital’
 - But, what are rules of access—especially in societies where social identity correlates with economic status?
 - Necessity of problematic ‘distance-bridging’ social capital to manage shared/covariant shocks

Crowding-In Productive Investment by the Poor

- Clear that we cannot ignore the quality of growth
- Equally clear that while we can be market friendly, we cannot be market naïve in the face of increasingly important fixed costs and recalcitrant rural financial markets
- Now is the time to match the past two decades' emphasis on extricating government from markets with state support for markets in which the poor can fully participate
- We need to crowd-in investments by the poor by making time and markets work for, not against them

Crowding-In Productive Investment by the Poor

- Concretely this means
 - Facilitating asset transfers to eliminate the destructive vulnerability of asset poverty
 - And yes, fixing rural financial markets
- Not easy, but ideas are there to try
- Failure would mean the perpetuation of both poverty and ‘aid traps’
 - [see Barrett, C.B. and M.R. Carter, “Can’t Get Ahead for Falling Behind: New Directions for Development Policy to Escape Poverty and Relief Traps,” *Choices* (forthcoming)].